89-730 (1)

Supreme Court, U.S.
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No.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1989

GERALD PATRICK DIETRICK AND
ANITA LEA DIETRICK,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
For the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Internal Revenue Service improperly and unfairly denied Petitioner his right as a taxpayer to deduct certain business expenses he paid on behalf of a closely held corporation for the primary purpose of protecting and promoting his sole proprietorship and the reputation thereof?

2. Whether the Internal Revenue Service incorrectly concluded that Petitioner is not entitled to deduct the expenses he paid on behalf of the closely held corporation when Petitioner was not reimbursed by the corporation for these payments?

TABLE OF CONTENTS

	Page
Questions Presented	i
Table of Authorities	v
Opinions Below	2
Jurisdiction	2
Statutory Provisions Involved	2
Statement of The Case	2
Reasons for Granting the Writ	10
I. Petitioner, Utilizing A Recognized Cash Accounting Method, Deducted The Expenses He Paid On Behalf Of A Closely Held Corporation Because His Motivation As A Self-Sustaining Entrepreneur Was To Protect And Promote His Sole Proprietorship, Dietrick Sales & Service	10
A. Petitioner Met The First Prong Of The Lohrke Test By Showing That The Expenses Were Paid To Protect And Promote His Sole Proprietorship	14
B. Petitioner Met The Second Prong Of The Lohrke Test By Showing That The Expenses Paid By Petitioner Were Ordinary And Necessary To Taxpayer's Business	20

C. Today's Entrepreneur Is A Man of Action Implementing New And Innovative Ideas And As Such Should Not Be Restrained By The Preference Of Form Over Substance Or By The Limited Foresight Of Others 22

II. Monies Transferred From Composite To Petitioner Were Loans Which Petitioner Was Obligated To Repay And Not Reimbursement For Expenses Paid By Petitioner 24

III. The Constitution of The United States Guarantees Every Citizen The Right To Life And Therefore The Right To Take All Legally Permissible Action An Entrepreneur Determines Is Necessary For the Support And Enjoyment Of His Own Life 26

Conclusion 30

Appendix A
Opinion of the United States Court of Appeals for the Sixth Circuit, Gerald Patrick Dietrick and Anita Lea Dietrick v. Commissioner of Internal Revenue, Nos. 88-1986 and 88-1998, dated August 10, 1989 ..... A-1

Appendix B
Judgment of the United States Court of Appeals for the Sixth Circuit, dated August 10, 1989 ..... A-16

Appendix C
Memorandum Opinion of the United States Tax Court, Gerald Patrick Dietrick and Anita Lea Dietrick v. Commissioner of Internal Revenue, Nos. 13616-84 and 42129-84, dated April 28, 1988 ..... A-18

Appendix D
Judgment of the United States Tax Court, No. 13616-84, dated June 30, 1988 ..... A-77

Appendix E
Judgment of the United States Tax Court, No. 42129-84, dated June 30, 1988 ..... A-79

Appendix F
26 U.S.C. Sec. 162(a) A-81

TABLE OF AUTHORITIES

Cases: Page

1. Berthold v. Commissioner, 404 F.2d 119 (6th Cir. 1968) 25

2. Commissioner of Internal Revenue v. Makransky, 321 F.2d 598 (3rd Cir. 1963) 25

3. Deputy v. du Pont, 308 U.S. 488 (1940) 10

4. Dinardo v. Commissioner, 22 T.C. 430 (1954)..... 13,14

5. Estate of Chism v. Commissioner, 332 F.2d 956 (9th Cir. 1963)..... 25

6. Gould v. Commissioner, 64 T.C. 132 (1975)..... 12

7. Jenkins v. Commissioner, 47 T.C.M. 238 (1983)..... 17,18

8. Lohrke v. Commissioner, 48 T.C. 679 (1967)..... 11,12,14,17,20

9. Manischewitz Co. V. Commissioner, 10 T.C. 1139 (1948) 20

10. Nasser v. United States, 257 F.Supp. 443 (N.D. Cal. 1966) 25

11. Pepper v. Commissioner, 36 T.C. 886 (1961)..... 11

Page

13. Snow v. Commissioner, 31 T.C. 585 (1958)..... 11,12

Statutes:

28 U.S.C. Sec. 1254(1) 2

26 U.S.C. Sec. 162 11

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COMMISSIONER OF INTERNAL REVENUE,
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On Petition for a Writ of Certiorari
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For the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioner respectfully prays that a Writ of Certiorari be issued to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit, entered on August 10, 1989.

OPINIONS BELOW

The Opinion of the Sixth Circuit Court of Appeals (Appendix A) is reported at 881 F.2d 336. The Opinion of the United States Tax Court (Appendix C) is reported at 55 T.C.M. 706.

JURISDICTION

The judgment of the Court of Appeals (Appendix B) was entered on August 10, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1) (1988).

STATUTORY PROVISIONS INVOLVED

The relevant portion of the Internal Revenue Code, 26 U.S.C. §162(a) is set forth in Appendix F.

STATEMENT OF THE CASE

Since 1959, Gerald Patrick Dietrick and Anita Lea Dietrick (hereinafter referred to as "Petitioner") have operated a sole proprietorship, Dietrick Sales & Service, which provided a broad range of engineering services in the areas of filtration equipment

and aircraft manufacturing. The combination of these diverse business interests into one sole proprietorship created a very complex operation.

In addition to being a registered professional engineer, Petitioner is an experienced pilot who served in World War II. In 1973, Petitioner acquired most of the operating assets of Windecker Industries, the former manufacturer of the Eagle airplane (hereinafter referred to as the "Eagle"). Prior to Petitioner's purchase, Windecker Industries had produced seven Eagles. The Eagle is a single engine airplane constructed of the revolutionary composite material known as nonwoven, unidirectional fiberglass material (hereinafter referred to as "NUF"). Petitioner initially marketed the Eagle through his sole proprietorship thereby committing his sole proprietorship to the business of aircraft manufacturing as stated on his personal tax returns.

Devoted to this enterprise, Petitioner labored tirelessly to ensure the success of Dietrick Sales & Service including the Eagle project. It soon became apparent that the success of the Eagle project would require virtually all of Petitioner's time and efforts, and therefore Petitioner hired an engineer to assist with the operation of the filtration equipment division of Dietrick Sales & Service.

By this time, Petitioner's sole proprietorship had peak revenues of $1,500,000.00, purchases of $750,000.00 and payroll and sales commissions of $250,000.00. In addition, his sole proprietorship had launched an aircraft manufacturing project with potential sales in excess of $25,000,000.00 per year.

Finally, as a result of the overwhelming complexity created by the amalgamation of these diverse business interests, Petitioner formed Composite Aircraft Corporation

(hereinafter referred to as "Composite") to be the new manufacturer of the Eagle. Petitioner contributed all but three of Petitioner's Eagle-related assets to Composite.

The crucial component in the production of the Eagle is the unique NUF material of which the Eagle is constructed. Petitioner retained individual ownership of the NUF machine and two Eagles. This NUF machine, the only one in existence, supplied this revolutionary material to various industries on behalf of Dietrick Sales & Service. As the sole supplier of NUF material, Dietrick Sales & Service remained inextricably linked with Composite.

The key factor to the success of the Eagle project was financing and the sale of aircraft engineering and maintenance services. Petitioner devoted virtually all of his time to the promotion of Composite by exhibiting his personal Eagles at airshows, participating in races and publishing a newsletter about the

Eagle. All of the travel and advertising expenses in question were incurred personally by Petitioner in his pursuit to promote the Eagle project. Promotion of the project would in turn further the interests of Dietrick Sales & Service through the sale of NUF material to Composite as well as to other manufacturers.

In addition, Petitioner leased his Eagle to various parties as a demonstration model thereby promoting the Eagle project and the sale of NUF. Most of the trips taken by Petitioner had dual purposes - to promote the Eagle project as well as to transact business on behalf of Dietrick Sales & Service.

During the recession between 1981 and 1983, the survival of both Dietrick Sales & Service and Composite was due to rental, engineering, and maintenance income earned on the Brico aircraft contract which was a direct result of the promotional efforts of Petitioner. The Brico contract involved the

leasing of Petitioner's individually owned Eagle to Composite, which in turn leased the Eagle to Brico for experimentation and use as a prototype for military aircraft overseas. In addition, the Brico contract involved engineering consultation and service work with possible guarantees of future business.

In 1982 alone, the use of Petitioner's Eagle and his engineering and aircraft service operations generated approximately $189,000.00 of income for Composite. Furthermore, Petitioner, on behalf of Composite, negotiated a lease with the United States Army under which the Army agreed to pay Composite $15,000.00 per month for the use of Petitioner's Eagle and in turn Composite paid Petitioner a rental fee. The rental income was the direct result of the expenses in question. Dietrick Sales & Service, the sole proprietorship, and Composite were inextricably intertwined and dependent on each other for survival during the years in question.

In an effort to raise capital, Composite extended three private offerings which fell far short of the necessary capital to begin production of the Eagle. Petitioner used his personal funds to pay Composite's expenses utilizing "Account 22" of his sole proprietorship to record the expenses. Account 22 from a financial and business perspective, accurately detailed the accounting relationship between Dietrick Sales & Service and Composite.

During 1980 and 1981, Composite made several loans to Petitioner and the 1981 Offering Circular characterized the transfers as "loans" from Composite to Petitioner. This money was loaned to Petitioner to enable him to continue to operate his various enterprises during the recession. Composite was not operational at the time and so the money would have been invested in some other manner if it had not been loaned to Petitioner. At that time, loans were difficult to obtain and so

the transactions were mutually beneficial to Composite, Dietrick Sales & Service and Petitioner.

Although Petitioner controlled Composite, as a borrower, Petitioner was obligated to repay these loans and he fully intended to repay the borrowed monies. In addition to other financing, Composite obtained a bank loan in the amount of $65,000.00 secured by the Treasury Bills owned by Composite. In order to reduce his debt to Composite, Petitioner repaid $25,000.00 of the bank loan prior to the institution of this suit.

The aircraft portion of the business has been abeyant since the initiation of this suit. In November 1988, the Internal Revenue Service issued an assessment and filed liens against Petitioner and as a result Petitioner is being forced to sell the aircraft business. Not only have Petitioners been forced to liquidate virtually all of their assets to

satisfy the assessment which has more than doubled due to the interest and penalties for late payments, Petitioners have been compelled to begin a new productive life at age 65.

REASONS FOR GRANTING THE WRIT

I. Petitioner, Utilizing A Recognized Cash Accounting Method, Deducted The Expenses He Paid On Behalf Of A Closely Held Corporation Because His Motivation As A Self-Sustaining Entrepreneur Was To Protect And Promote His Sole Proprietorship, Dietrick Sales & Service.

Section 162 of the Internal Revenue Code provides that a trade or business expense is deductible only if it is an ordinary and necessary expense paid or incurred in carrying on a trade or business. This Court established the proposition that a taxpayer may not deduct expenses incurred on behalf of another taxpayer's business. Deputy v. du Pont, 308 U.S. 488, 494 (1940).

However, an exception to this general rule has been established where a taxpayer

pays the business expenses of another to "protect or promote" his own trade or business. Lohrke v. Commissioner, 48 T.C. 679, 684 (1967); Pepper v. Commissioner, 36 T.C. 886, 895 (1961); Snow v. Commissioner, 31 T.C. 585, 591 (1958). In the present case, even though the debt accrued to another entity, Petitioner should be permitted to deduct the expenses he paid under Section 162(a) of the Internal Revenue Code. Id.; 26 U.S.C. §162(a) (Supp. 1988).

In the leading case, Lohrke, the Tax Court enunciated the two-prong test for this exception: first, the taxpayer's motive for paying the obligation of the other entity must be to protect and promote the taxpayer's own business, and second, the expense must be an ordinary and necessary expense of the taxpayer's trade or business. Lohrke, 48 T.C. at 688. "The crucial and controlling factor lies in determining whether the acts done and expenditures made were motivated by a purpose

to protect or to promote the taxpayer's business or were made as an investment in a new enterprise." Snow v. Commissioner, 31 T.C. 585, 591 (1958); Gould v. Commissioner, 64 T.C. 132, 134 (1975).

In Lohrke, the taxpayer held a patent on a process employed in the synthetic fiber industry from which he received substantial royalty income under several licensing agreements. Lohrke v. Commissioner, 48 T.C. 679 (1967). The taxpayer was also a major stockholder in one of the companies licensed to use this process. This particular company made a shipment of defective fiber to a customer and as a result, the continuing existence of the company was threatened. In an effort to save the company, the taxpayer agreed to assume any loss the customer suffered.

The Court concluded that the taxpayer's primary motive for paying the obligation of the company was to protect his

own licensing business which received and would continue to receive benefits from the continuing existence of the company. These benefits included using the company as a model so prospective licensees could sample the fiber and as a guide to gain knowledge of trade activities so the taxpayer would know if other companies were using the process without a license.

The theory of "protect or promote" was utilized by the Tax Court in Dinardo v. Commissioner, 22 T.C. 430 (1954). The taxpayers formed a partnership for the practice of medicine and they also organized a nonprofit corporation which operated a private hospital. The hospital was beset with financial difficulties and the medical partnership agreed to pay the hospital's operating deficits to enable the hospital to continue operating. Allowing the deductions, the Court stated that the partnership did not pay the hospital's expenses in return for

profits from continuing operations, but rather the payments were made to ensure the continuing operation of the hospital so that the medical partnership could earn medical fees from patients who were hospitalized there. Dinardo, 22 T.C. at 435.

A. Petitioner Met The First Prong of The Lohrke Test By Showing That The Expenses Were Paid To Protect And Promote His Sole Proprietorship.

The first prong of the Lohrke test requires that the taxpayer demonstrate that his "ultimate purpose in paying [the other taxpayer's] obligation was [not] to keep [the other taxpayer] in existence, thereby perhaps realizing a return on his payment through corporate profits, ...[but rather] his purpose was to protect or promote his own business realizing a return on his payment through continued profits in that business." Lohrke, 48 T.C. at 688. Contrary to the decision of the Court of Appeals, Petitioner fulfilled

this requirement by demonstrating that his motive for paying the expenses of Composite was to protect and promote Dietrick Sales & Service.

The business of Dietrick Sales & Service encompasses a broad range of fields including engineering services specializing in designing, manufacturing, and selling filtration equipment and designing aircraft. Initially, the Eagle project was part of Petitioner's sole proprietorship before the project was transferred to Composite; however, Dietrick Sales & Service continued in the aircraft business by retaining the NUF machine and the Eagle aircraft. In determining whether Petitioner's "ultimate purpose" was to "protect or promote" his sole proprietorship, the Court of Appeals ignored the fact that Petitioner continued to be involved in both the filtration and aircraft business as indicated on his personal tax returns. Petitioner paid the expenses of

Composite to protect both of these businesses and not for the primary purpose of earning a return on his investment in Composite.

The single largest market for NUF material was the aircraft industry. The financial future of the NUF business of Dietrick Sales & Service depended on securing a buyer and cultivating a market for NUF material, namely Composite. As the first NUF airplane, the sale and success of the Eagle produced by Composite was crucial to the future sales of NUF by Dietrick Sales & Service. The Eagle was the first of its kind to utilize this unique NUF material. Creating an awareness of this new fiber and increasing the visibility of the product were the keys to future marketability of NUF by Dietrick Sales & Service.

If Composite was never operational, then Dietrick Sales & Service would not have any customers and virtually no demand for NUF. Composite was the key to developing and

expanding a market for NUF and for this reason alone, Petitioner agreed to provide NUF at cost to Composite. If Composite failed, Petitioner's sole proprietorship would lose the value of its investment in the NUF machine in addition to the profits it would gain on the other sales of NUF. As a result, Dietrick Sales & Service would suffer severe financial consequences.

In addition, a subdoctrine has been developed extending the Lohrke exception to the protection of a business, goodwill or reputation thereof as a sufficient basis for paying the expenses of another, and thereby properly deducting those expenses under Section 162 of the Internal Revenue Code. This theory was developed in Jenkins v. Commissioner, 47 T.C.M. 238 (1983), in which the Tax Court recognized that where a taxpayer has demonstrated a proximate relationship between the failure of a corporate enterprise and the "possibility of extensive adverse

publicity concerning Petitioner's involvement in the defunct corporation" which has the potential to harm the taxpayer's business, payment of the corporation's debts may serve to "protect or promote" the taxpayer's business and thus may be deducted.

In Jenkins, supra, the taxpayer repaid investors, who were friends and business associates, that had invested in the financially troubled Twitty Burger Corporation. The taxpayer, country music entertainer Conway Twitty, believed that failure to indemnify his co-investors would certainly damage his reputation. The Court determined that Twitty's motive was to protect his personal business reputation in his on-going business as a country music entertainer. Furthermore, extensive adverse publicity connecting the taxpayer with the defunct corporation would reflect unfavorably upon the taxpayer's reputation. Consequently,

the Court concluded that the taxpayer was entitled to corresponding deductions.

Contrary to the decision of Court of Appeals, Petitioner was forced to pay the expenses of Composite to avoid any adverse impact on his business reputation. Failure to pay Composite's expenses would have resulted in a loss of investment by both the Petitioner and other investors and damage to Petitioner's business reputation. A poor business reputation would be fatal to attracting potential investors to Composite or any other venture initiated by Petitioner. In addition, a solid business reputation was necessary to maximize the sale of NUF, which figured largely in the future of both Dietrick Sales & Service and Composite. Therefore, Petitioner had to bolster Composite financially, or face the possibility of endangering his business reputation and a corresponding decline in the success of Composite as well as Dietrick Sales & Service.

B. Petitioner Met The Second Prong Of The Lohrke Test By Showing That The Expenses Paid By Petitioner Were Ordinary And Necessary To Taypayer's Business.

The second prong of the Lohrke test requires that the expense be an ordinary and necessary expense of taxpayer's business. Lohrke, 48 T.C. at 688. The Court in Manischewitz Company v. Commissioner, 10 T.C. 1139 (1948), set forth the standards for "ordinary and necessary". The term "ordinary" means that the expenditures are a common and accepted method of protecting and promoting a business. Likewise, the Court decided that the concept of "necessary" was equivalent to an expenditure which was "appropriate and helpful." Manischewitz, 10 T.C. at 1145. The Court stressed that the subjective nature of these terms and the importance of viewing these situations in its entirety.

In the present case, the expenditures in dispute fall within the guidelines of an ordinary and necessary business expense. The

expenses relating to the storage of machinery used to produce the Eagle, advertising and travel for the promotion of the Eagle, wages paid to engineers redesigning the Eagle, and the other disallowed expenses were incurred by Dietrick Sales & Service in publicizing the Eagle project which in turn generated income for Dietrick Sales & Service. The disallowed deductions included expenses which were incurred by Petitioner when he used his personal Eagle in activities aimed at promoting Composite. The expenses were ordinary for a business such as Dietrick Sales & Service which was promoting the growth of its aircraft enterprise.

Entrepreneurs are unique individuals. It takes creativity and nimbleness to turn a new and struggling enterprise into a flourishing business. Financing is a key factor in the survival of a new enterprise, and sometimes creative leadership is necessary for an enterprise to survive during the lean

years. Petitioner, as an entrepreneur and sole proprietor of Dietrick Sales & Service, incurred expenses on behalf of Composite and in furtherance of the aircraft business of Dietrick Sales & Service at a time when the filtration business of Dietrick Sales & Service was in a decline.

C. Today's Entrepreneur Is A Man Of Action Implementing New And Innovative Ideas And As Such Should Not Be Restrained By The Preference Of Form Over Substance Or By The Limited Foresight Of Others.

Modern entrepreneurs represent the embodiment of the principal of an individual's right to own the property they earn which is the sum and substance of our Constitution. As long as any citizen does not act fraudulently and is not a criminal, he maintains the right to pursue his life as a rational being. However, the United States government through the Internal Revenue Service, restricts an entrepreneur's right to rationally expend his

funds for legitimate business purposes by denying the corresponding tax deductions which should be afforded such expenditures. In effect, the United States government, is denying today's entrepreneur the fundamental constitutional right to reason with his own mind and to determine the best course for his business within the boundaries of the law.

Petitioner is a model representative of today's self-sustaining entrepreneur who is the very foundation for the competitive edge of the United States against any subsidized domestic or foreign competitors. Petitioner utilized an accurate and recognized accounting system to record all of the transactions relative to his various enterprises. As noted by the Tax Court, if Petitioner had filed a Subchapter S Election then his deductions would be completely proper. However, because Petitioner innocently overlooked the filing of a form, his heretofore deductions suddenly become improper. When procedures become

become inflexible barriers instead of educational guidelines, the result is a severe blow to free enterprise, the sum and substance of our Constitution.

Clearly, Petitioner is not a criminal and did not act fraudulently in any manner. In conjunction with the investigation by the Internal Revenue Service and the Tax Court, Petitioner cooperated to the fullest extent possible with all parties involved. When a citizen can rationally justify his actions, the government should not have the right to to deny any citizen his right to conduct business in a reasonable manner and to own the property he earns.

II. Monies Transferred From Composite To Petitioner Were Loans Which Petitioner Was Obligated To Repay And Not Reimbursement For Expenses Paid By Petitioner.

The transfer of money from Composite to Petitioner was a loan and not reimbursement to Petitioner for expenses paid by Petitioner on

behalf of Composite. To determine whether a distribution from a corporation is a loan, the courts focus on the intent of the parties to repay the monies. Berthold v. Commissioner, 404 F.2d 119, 122 (6th Cir. 1968); Nasser v. United States, 257 F.Supp 443, 447 (D.C. Cal. 1966). Intent to repay is measured by the actual intent that the money advanced will be repaid and not by what the transaction is called or by what form it takes. Commissioner of Internal v. Makransky, 321 F.2d 598 (3rd Cir. 1963). This is a question of fact to be determined from all the circumstances. Estate of Chism v. Commissioner, 322 F.2d 956, 960 (9th Cir. 1963).

The funds transferred to Petitioner were in fact loans to Petitioner. The 1981 Offering Circular characterized the transfer of monies from Composite to Petitioner during 1980 and 1981, as "loans". The loans to Petitioner were a form of investment until Composite became operational and thereby

benefited both Composite and Dietrick Sales & Service.

At the outset Petitioner intended to repay these loans, not to mention the fact that he was personally obligated to repay these loans. In his testimony before the Tax Court, Petitioner stated that he obtained the loans from Composite. In addition, Composite secured a bank loan in the amount of $65,000. Petitioner repaid $25,000 of this $65,000 loan when the bank note came due. Thus, the transfers to Petitioner were loans and not reimbursements for expenses paid by Petitioner.

III. The Constitution of The United States Guarantees Every Citizen The Right To Life And Therefore The Right To Take All Legally Permissible Action An Entrepreneur Determines Is Necessary For The Support And Enjoyment Of His Own Life.

The United States has the ideal democratic system in which an individual citizen may do anything except that which is

legally forbidden, while the government may not do anything except that which is legally permitted. The Constitution guides the government which cannot expand its powers without the vote of the people. Furthermore, the Constitution forbids our government from taking away the right of the citizen to reason with his own mind and to make a rational decision.

Man can derive enormous benefits from dealing voluntarily with one another in an atmosphere of freedom to think and to act according to each individual's rational judgment. However, man needs a referee and protection from criminals which is the fundamental purpose of government. The people have given the government exclusive use of this power so that the government can protect the rights of citizens against criminals.

When the bureaucratic government assumes powers that it has not been legally granted, the responsibility of curbing this expansion

rests with the Justice Department and ultimately the Supreme Court of the United States. In the past the government guaranteed individuals a right to life, liberty and the pursuit of happiness, but now the government restricts a person's right to reason to the extent that now the government directs the pursuit of life and liberty.

Our country is based on the Constitution and the principle of democracy which protects individual rights to life, liberty, and earn and retain property. If the government is permitted to restrain these rights of law abiding, tax paying citizens, then we will no longer have the Constitution as we know it. Under such circumstances, any incentives, let alone opportunities for entrepreneurs, will disappear along with any remnants of a democratic society.

Petitioner represents today's modern day entrepreneur. An entrepreneur is a businessman with a vision to create or improve

a product or service for society in exchange for monetary compensation or other rewards. The entrepreneur can only flourish in a capitalist society where he is motivated and rewarded for his efforts. Capitalism is the political system based on the theory that a person is granted the freedom to exercise his individual rights. The primary individual right is the right to life which means the right to engage in self-sustaining and self-generating action -- which in turn means the freedom of an individual to take all the actions required by the nature of a rational being for the support, the fulfillment and the enjoyment of his own life.

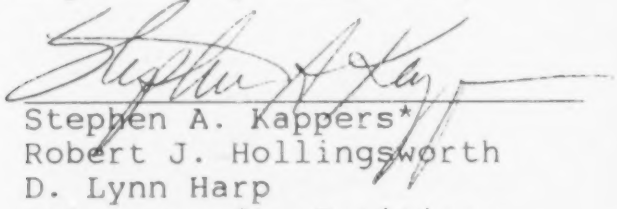
The entrepreneur represents the embodiment of the principle of individual rights in a capitalist society. Thus, he is seen as the leader of the United States in the country's attempt to maintain its greatness. Should the opinion of the Sixth Circuit Court of Appeals be allowed to stand, the United

States through the Internal Revenue Service will restrict an entrepreneur's right to freely expend his funds for legitimate business purposes by denying the concommitant tax deductions which should be afforded such expenditures. The United States is removing the motivation of the entrepreneur, to the detriment of the rest of society.

CONCLUSION

For the foregoing reasons, Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,



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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Nos. 88-1986
88-1998

GERALD PATRICK DIETRICK;
ANITA LEA DIETRICK
Petitioners-Appellants,

V.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeals from the United States Tax Court

Decided and Filed August 10, 1989

Before MARTIN, Circuit Judge,
JONES, Circuit Judge, and
COOK*, District Judge.

BOYCE F. MARTIN, JR., Circuit Judge.

The taxpayers[1] appeal the Tax Court's decision

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* The Honorable Julian A. Cook, Jr., United States District Judge for the Eastern District of Michigan, sitting by designation.

[1] Anita Lea Dietrick is a party to this action only because she signed the joint returns prepared by her husband.

finding deficiencies in his 1980 and 1982 returns in the amounts of $70,864.45 and $38,421.03. The following issues are raised on appeal: Were the expenses paid by the taxpayer on behalf of a closely held corporation to "protect or promote" his business? Was the taxpayer partially reimbursed through an incorrect deduction for expenses he paid on behalf of a closely held corporation? Consideration of these issues involves a review of the Tax Court's findings of fact.

We review the Tax Court's finding of fact under the clearly erroneous standard. Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989).

The taxpayer owned and operated Dietrick Sales and Services as a sole proprietorship engaged principally in the sale and service of filtration equipment from 1959 until 1982 when the business was incorporated. In 1977, the taxpayer acquired the assets of Windecker

Industries, Inc., a business which had been engaged in the manufacture of airplanes constructed with a composite material known as NUF, a nonwoven, unidirectional fiberglass material. In 1979, the taxpayer established the Composite Aircraft Corporation, and transferred to it all the assets used in the manufacture of the aircraft except the machine which produced NUF, in exchange for 310 shares of the new corporation.

Composite issued three different offering circulars in 1979, 1980, and 1981 in the hope of attracting the capital necessary to begin production. The 1979 circular stated:

> In some instances, Dietrick has advanced funds to cover the expenses indicated [above] and he will be reimbursed therefore from the proceeds of this offering. He may also elect in the future to advance funds on behalf of the Company to cover expenses and he will be reimbursed for such advances from the proceeds of this offering available at the time.

The 1979 and 1980 offerings produced a total of $160,800 in capital. The 1981 offering produced $9,750. Prior to the 1981 offering, the $160,800 from the first two offerings was advanced to the taxpayer in what the 1981 Offering Circular termed a "loan." The 1981 circular did state that the taxpayer would repay the $160,800 "pursuant to promissory notes executed in favor of the Company." However, no promissory note was ever executed, nor was a time for repayment set, and the taxpayer was not obligated to pay interest on the "loan." Composite subsequently borrowed $65,000 from a financial institution, and when the note came due, the taxpayer personally paid $25,000 on the debt.

Composite hired George Alther as an engineer in 1979, but because of the risky nature of the Composite undertaking, the taxpayer agreed that if Composite did not become profitable, he would employ Alther in his filtration business. Because of

Composite's lack of financing, in 1980 and 1981, Alther in fact worked for the taxpayer's filtration business. He devoted approximately 90 percent of his time to the filtration business, and 10 percent to Composite.

In 1980, 1981 and 1982, the taxpayer utilized and designed in his books Account 22 to pay expenses incurred by Composite, including the salary of George Alther. For 1980, these expenses totaled $137,638.31, and the taxpayer deducted most of these expenditures as ordinary and necessary expenses of his sole proprietorship on Schedule C of his 1980 return. These expenses helped to generate a net operating loss of $84,392.97 for the taxpayer in 1981 which was carried over to 1982. In 1982, the taxpayer deducted a total of $4,082.37 in Account 22 expenditures.

Following a trial the Tax Court concluded that the taxpayer was not entitled to claim a deduction for the expenses which he

incurred on behalf of Composite. In particular, the Tax Court rejected the taxpayer's argument that he had paid Composite's expenses in order to protect and promote his sole proprietorship, and hence was entitled to deduct the expenses he incurred for Composite. The court found that "petitioner's primary motive for paying Composite's expenses was to establish a new business rather than protect or promote his sole proprietorship."

The Tax Court further concluded that even if the taxpayer did fall within the protect-or-promote exception, he still would not be entitled to deduct all of the expenses he incurred on behalf of Composite because he was reimbursed by the transfers totaling $131,800 (the $160,800 "loan" less the $25,000 paid by the taxpayer on Composite's $65,000 debt to the financial institution). The court rejected the taxpayer's argument that the $160,800 was a loan, not reimbursement for the

expense he incurred on behalf of the corporation, specifically finding "on the basis of the record as a whole that petitioner has failed to establish that he had any obligation to repay, or intent to repay these funds to Composite."

The Tax Court did accept the taxpayer's argument that he was entitled to deduct 90 percent of the wages paid to Alther because 90 percent of work he did during the years in questions was on behalf of the taxpayer's filtration business. However, the court held that the deduction "must be reduced to the extent that petitioner was reimbursed for such expenditures by Composite." The government has not appealed the Tax Court's holding that the taxpayer may deduct 90 percent of Alther's salary. The taxpayer, however, has appealed the finding that he was reimbursed for a portion of those wages by the "loan" for Composite.

A taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...." 26 U.S.C.A. §162(a) (Supp. 1989). It has long been the general rule that a taxpayer may not deduct expenses incurred on behalf of another taxpayer's business. E.g. Deputy v. du Pont, 308 U.S. 488, 494 (1940). Similarly, a shareholder ordinarily may not deduct expenses he has incurred on behalf of a corporation. "When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially a product of his services, legally arises not from his own trade or business but from that of the corporation." Whipple v. Commissioner, 373 U.S. 193, 202 (1963).

The taxpayer acknowledges the general rule, but argues that he falls within a narrow

exception carved out by the Tax Court for cases in which the taxpayer's payment of the business expenses of another serves to "protect or promote" his own business. See generally, Lohrke v. Commissioner, 48 T.C. 679 (1967). The Tax Court rejected this argument as we do. The Tax Court found that even if the payments did fall within the narrow exception to the general rule, the taxpayer still could not deduct the bulk of the payments because the "loan" from Composite to the taxpayer partially reimbursed him for the expenditures in question.

In Lohrke, the Tax Court set forth a two-prong test for determining whether a taxpayer must demonstrate that his "ultimate purpose in paying [the other taxpayer's] obligation was [not] to keep [the other taxpayer] in existence, thereby perhaps realizing a return on his payment through continued profits in that business." 48 T.C. at 688; see also Snow v. Commissioner, 31 T.C.

585, 591 (1957). The taxpayer must also show that the expense is an ordinary and necessary expenditure in furtherance of his trade of business--not in furtherance of the trade or business of the other taxpayer. 48 T.C. at 688.

In applying the first prong of the Lohrke test, courts have insisted that there be "a clear proximate danger to the taxpayer and . . . a payment made to protect an existing business from harm." Young & Rubicam, Inc. v. United States, 410 F.2d 1233, 1243 (Ct. Cl. 1969). Where the taxpayer fails to demonstrate "a direct nexus between the purpose of the payment and the taxpayer's business or income producing activities," the deduction will not be allowed. Lettie Page Whitehead Foundation, Inc. v. United States, 606 F.2d 534, 538 (5th Cir. 1979).

As the Tax Court found, the taxpayer did not meet his burden of showing that his "ultimate purpose" in this case was to

"protect or promote" his filtration business, and not to earn a return on his investment in Composite. The taxpayer's sole proprietorship received no business whatever from Composite during the years in question. The taxpayer essentially argues that the sole proprietorship had a great interest in the success of Composite because it hoped to earn large profits selling NUF produced by the machine which it owned. This argument, however, is undercut by the fact that the taxpayer agreed to provide NUF at cost to Composite. Thus the taxpayer has not shown that the sole proprietorship benefited in any way from the continued existence of Composite.

The taxpayer also argues that he was forced to pay the expenses of Composite in order to protect his business reputation. The Tax Court has recognized that where a taxpayer has demonstrated a proximate relationship between the failure of a corporate enterprise and the "possibility of extensive adverse

publictiy concerning a petitioner's involvement in the defunct corporation" which has the potential to harm the taxpayer's business, payment of the corporation's debts may serve to "protect or promote" the taxpayer's business and thus may be deducted. Jenkins v. Commissioner, 47 T.C.M. 238, 246 (1983). In Jenkins, the Tax Court based its conclusion that the taxpayer's business could be potentially harmed by the adverse impact of the failure of the corporation upon the taxpayer's reputation on extensive testimony from both the taxpayer and an expert witness. This testimony demonstrated both that the failure of the corporation would adversely affect the taxpayer's reputation and that the harm to the taxpayer's reputation had a proximate relationship to potential harm to his business. In contrast, as the Commission points out, the taxpayer has introduced no evidence showing that the failure of Composite will have an adverse impact on his business

reputation, nor has he demonstrated that it could harm his filtration business.

In sum, the Tax Court's conclusion that the taxpyer's "primary motive for paying Composite's expenses was to establish a new business" is, at the very least, plausible in light of the record considered as a whole. Thus the Tax Court's finding that the taxpayer's payment of Composite's expenses did not serve to "protect or promote" his own business was not "clearly erroneous."

We turn now to the Tax Court's finding that the advances from Composite to the taxpayer were not loans. "[T]he intention of the parties is the controlling factor in determining whether or not advances should be termed as loans." Berthold v. Commissioner, 404 F.2d 119, 122 (6th Cir. 1968). The Tax Court bases its finding that the parties intended the advance in this case to be reimbursement for expenses paid, not a loan to the taxpayer on (1) the fact that no note was

executed by the parties; (2) the fact that the taxpayer was not obligated to pay interest; (3) the fact that no time was set for repayment of the "loan"; (4) the incongruity of a corporation in desperate need of financing making such a large loan; (5) the fact that there was no collateral securing the "loan" other than the taxpayer's shares in the corporation; (6) the fact that the 1979 offering circular indicated that the taxpayer would be reimbursed for the expenses he paid on behalf of the corporation; and (7) the fact that the taxpayer indicated that he may not have to repay the "loan" if Composite failed. All of these factors may be considered by the fact finder in determining whether or not an advance may be considered a loan. Alterman Foods v. United States, 505 F.2d 873, 878-79 (5th Cir. 1974); Berthold, 404 F.2d at 122.

Clearly the Tax Court's conclusion that the parties intended the payment as reimbursement for the expenses paid by the taxpayer and not as a loan is plausible in light of these facts.

The decision of the Tax Court is affirmed.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

GERALD PATRICK DIETRICK AND
ANITA LEA DIETRICK,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent-Appellee.

Before: MARTIN and JONES, Circuit Judges;
and COOK, District Judge.

No. 88-1986/1998

JUDGMENT

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said tax court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said tax court in this cause be and the same is hereby affirmed.

IT IS FURTHER ORDERED that Respondent-Appellee recover from Petitioners-Appellants the costs on petition, as itemized below.

ENTERED BY ORDER OF THE COURT

Leonard Green, Clerk

_____

Clerk

Issued as Mandate: September 12, 1989.

COSTS: None

Filing fee ..... $
Printing ..... $
Total ..... $

ATTEST:

_____

Deputy Clerk

APPENDIX C

UNITED STATES TAX COURT

Nos. 13616-84
42129-84

GERALD PATRICK DIETRICK AND
ANITA LEA DIETRICK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Filed April 28, 1988.

Stephen A. Kappers, for the petitioners.[1]

Genevieve K. Murtaugh, for the respondent.

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[1] Petitioners appeared pro se at the trial. They retained counsel after trial to prepare their post-trial briefs.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, Judge: In these consolidated cases, respondent determined deficiencies in petitioner's Federal income tax for the calendar years 1980 and 1982 as follows:

Docket No.	Year	Deficiency
13616-84	1980	$70,864.55
42129-84	1982	38,490.19

After a concession by petitioners, the issues for decision are:

(1) Whether the taxpayer, who incurs and pays expenses for his closely held corporation from which his sole proprietorship possibly may later derive income, is protecting or promoting his sole proprietorship and so may deduct the corporation's expenses on his Schedule C.

(2) If the taxpayer is found to be protecting or promoting his sole proprietorship, whether he may deduct the corporation's expenses when the corporation

has transferred funds to him. This depends upon whether the corporation's transfers of funds to him are loans or reimbursements for the corporate expenses he has paid.

(3) Whether the taxpayer may deduct under section 162[2] a certain percentage of the wages paid to an employee of a corporation if the employee did work for the taxpayer's sole proprietorship as an agent of the corporation.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, supplemental stipulation of facts, and the exhibits attached thereto are incorporated herein by this reference.

Petitioners Gerald Patrick Dietrick and Anita Lea Dietrick resided in Florence,

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

Kentucky at the time of the filing of their petitions. Petitioners filed their joint Federal income tax returns (Forms 1040) for the taxable years 1980, 1981, and 1982, and an amended individual income tax return (Form 1040X) for the taxable year 1982 with the Internal Revenue Service Center in Memphis, Tennessee. Petitioner Anita Lea Dietrick is a party in this case solely because she filed joint income tax returns with her husband for each of the years in issue. All further references to "petitioner" are to Gerald Patrick Dietrick.

In approximately 1959 petitioner began operating a sole proprietorship known as Dietrick Sales and Service. This business provided a wide variety of engineering services, which primarily included the sales and service of filtration equipment, water waste treatment, tramp oil systems and oil water separators, generally referred to as the filtration operation.

Petitioner became interested in the Windecker Eagle Airplane (hereinafter referred to as the Eagle) in 1973 when he bought an Eagle from Windecker Industries, Inc. The Eagle is a single engine, high performance aircraft constructed of a composite material known as NUF, or nonwoven, unidirectional fiberglass material. The Eagle was first conceived by Dr. Leo J. Windecker, a dentist who devoted substantial time to aircraft research and development. Dr. Windecker incorporated Windecker Industries, Inc. in 1967 primarily for the purpose of developing, manufacturing, and marketing the Eagle.

Petitioner had no experience in the aircraft industry other than as a private pilot. Petitioner became convinced that the Eagle could be commercially successful and proceeded to acquire certain indebtedness of the financially troubled Windecker Industries, Inc. The indebtedness petitioner acquired was secured by various assets of Windecker

Industries, Inc. that were required to manufacture the Eagle. Windecker Industries, Inc. had obtained a Federal Aviation Administration (FAA) Type Certificate on the Eagle and had manufactured seven of the aircraft before it defaulted on its indebtedness. Petitioner then foreclosed on his security interests and obtained machine tools, production molds, the FAA Type Certificate on the Eagle, aircraft tooling, the machine that manufactured NUF, trademarks and registered trade names, and engineering specifications. Petitioner then purchased substantial aircraft inventory that Windecker Industries, Inc. had on hand. Petitioner sold most of the machine tools, but retained the FAA Type Certificate and aircraft tooling, unique machine tools and production molds, as well as the machine that manufactured NUF.

Petitioner initially attempted to market the Eagle on his own through his sole proprietorship, Dietrick Sales and Service.

Petitioner later decided to set up a corporation for the manufacture and sale of the Eagle. Petitioner decided to incorporate for several reasons, including his belief that his Schedule C operation had become too complex and his desire to separate his various enterprises. Other reasons were his belief that the best way to finance the production of the Eagle was through contributing shareholders and his desire for an entity that would continue even if something were to happen to him. Thus, petitioner hired an engineer to take over the Dietrick Sales and Service filtration operation so petitioner could incorporate a company, Composite Aircraft Corporation, to produce the Eagle aircraft and devote his full time to the aircraft business.

On April 1, 1979, Composite Aircraft Corporation (hereinafter referred to as Composite) was organized under the laws of the State of Delaware. Composite filed a

corporation income tax return (Form 1120) for the taxable years 1980, 1981, and 1982, with the Memphis Service Center. In addition, Composite filed Employer's Quarterly Federal Tax Returns (Forms 941) for the four quarters of the calendar year 1980 with the Memphis Service Center.

At the time Composite was organized petitioner transferred to Composite all of the assets required for the production of the Eagle, except the NUF machine, that he had acquired from Windecker Industries, Inc., as well as know-how and engineering data in exchange for 310 shares of common stock in Composite. Under the FAA Type Certificate, Composite had the right to use the name "Windecker" in connection with the Eagle. Petitioner retained ownership of the NUF machine. The NUF machine was kept at the Dietrick Sales and Service plan in Midland, Texas. However, petitioner entered into a

contract with Composite to supply Composite with its requirements of NUF "at his cost."[3]

In addition to the assets transferred to Composite by petitioner, Composite sold a few shares of stock through three private offerings on April 1, 1979, March 1, 1980, and January 20, 1981, to obtain financing for the Eagle project. Each of the three offering circulars warned potential investors that "If Windecker Industries, which was larger and better capitalized than [Composite], was unable to manufacture and market the Eagle on a commercially successful basis, there can be no assurance that [Composite] will be able to manufacture and market the Eagle successfully." Petitioner was the controlling shareholder of Composite, owning over 90

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3 In brief petitioners argue that the agreement to furnish Composite's requirements for NUF "at his [Mr. Dietrick's] cost" somehow included some amount for profit. There is no evidence in the record to support that argument.

percent of the issued and outstanding stock at all times. Moreover, the purchasers of the stock were required to execute a Voting Trust Agreement authorizing petitioner to act as voting trustee and to vote all of their shares subject to the voting trust. These three offerings resulted in capital contributions to Composite from shareholders of $75,000 (12 shares x $6,250 per share) as of September of 1979, $85,800 (11 shares x $7,800 per share) as of June of 1980, and $9,750 (one share x $9,750 per share) as of February of 1981, for a total capital contribution of $170,550. These contributions fees far short of the $1.5 million that Composite had set as its original goal. Composite placed these funds in interest-bearing accounts and Treasury bills so the funds could earn interest. Petitioner used his own funds to pay the corporation's expenses, using Account 22 of Dietrick Sales and Service for that purpose.

Petitioner believed that the only way the Eagle could become commercially feasible was if the wing of the Eagle that Windecker Industries, Inc., had originally manufactured was redesigned. In September of 1979, Composite hired a full-time aeronautical engineer and hired the original designer, Dr. Leo J. Windecker, as a consultant. Composite hired George Alther (hereinafter referred to as Alther) as its aeronautical engineer. Alther had once been the chief engineer on the Eagle's original design team at Windecker Industries, Inc. Due to the risky nature of the new enterprise, petitioner and Alther orally agreed to a contingency plan under which Alther would switch to the filtration operation at the Dietrick Sales and Service plant in Midland, Texas, if Composite could not attract sufficient financing for the Eagle project. Since petitioner and Alther wanted to promote the Composite name, in early 1980 they decided to operate only under the

Composite name in Midland, Texas and to close out any reference to Dietrick Sales and Service in Midland. By 1981 all references made to the Midland, Texas plant referred to Composite only.

In 1980, petitioner paid Alther to perform services for Dietrick Sales and Service.[4] Petitioner drew twelve checks on his Dietrick Sales and Service account to Alther, each of which was for $2,864.35 with the notation "payroll," for a total of $34,372.20. Petitioner deducted these payments on his Schedule C as part of his cost of goods sold. In addition, petitioner drew a check on the Dietrick Sales and Service account in the amount of $1,650 with the notation "Fed. Tax Deposit for Composite Aircraft" for

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[4] At trial petitioner characterized these payments as having been made to Composite, suggesting that Alther performed the services for Dietrick Sales and Service as an agent of Composite. Consistent with that theory, petitioner also testified that Composite

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withholding taxes relative to Alther's salary. See n.4, supra. Petitioner also deducted this expenditure on his Schedule C as part of his cost of goods sold. Petitioner also recorded Alther's salary payments in Account 22, which was the account petitioner used to record the amounts he spent to pay Composite's expenses. The total amount of expenditures that petitioner included in Account 22 for 1980 was $137,638.31.

Since Composite was still unable to begin production of the Windecker Eagle due to the lack of financial capital, in 1981 Alter was assigned to do consulting work in the oil industry in which he had experience before he

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reported the payments from Dietrick Sales and Service to Alther as income on its corporate return. That is not the fact. On its 1980 corporate income tax return, Composite reported as income only the $12,865.44 interest income on the funds held in savings accounts and Treasury bills. While it did not report any income from these services performed by Alther, Composite did file Employer's Quarterly Federal Tax Returns (Forms 941) for that year.

became an employee of Composite. Although Alther was an employee of Composite, he did consulting work using the name "Alther Engineering" because his name was well known in the oil industry while Composite's name was not. During the years in issue here, all of Alther's W-2 forms were issued by Composite. The record does not disclose whether Composite had a separate bank account in 1980, but by 1981 it apparently did have one. Some of the consulting fees that Alther generated as Alther Engineering were deposited in the Composite corporate bank account and used to help pay Alther's salary and expenses for the year. During 1981, petitioner also wrote eight checks on the Dietrick Sales and Service account payable to George Alther totaling $20,050.45, which he classified as "wages," included in Account 22, and deducted on his Schedule C as cost of goods sold.[5]

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[5] Composite's 1981 corporate tax return reflected total gross income of only $13,812.21 and a deduction for wages of $5,728.70.

In early 1982, petitioner incorporated the filtration operations of Dietrick Sales and Service, and also incorporated Tailwinds Aviation, Inc., an aircraft service organization. The record does not disclose which of petitioner's various assets were transferred to each of these corporations. In particular, the record does not establish whether the NUF machine was transferred to the new Dietrick Sales and Service Corporation or Tailwinds Aviation or was retained by petitioner individually. There had been some sales of NUF in 1979, but there were no sales of such material during any of the years before the Court. The NUF machine had never been used to produce any NUF material for Composite up to the time of the trial. Neither petitioner nor Composite had ever produced an Eagle plan up to the time of the trial.

As president, director, and principal shareholder of Composite, petitioner spent a great deal of the time attempting to obtain financing for the airplane project through publicity for the plane. In his effort petitioner agreed to let Composite use his Eagle for demonstration and promotional purposes. Publicity for Composite included exhibiting the Eagle at air shows, taking part in races, and publishing the "Tail Feather," a newsletter about the Eagle. Each of Composite's Confidential Offering Circulars specified that since Composite did not have a full-time sales force, it would rely on petitioner's efforts to obtain orders for the Eagle at air shows and through personal contact with prospective customers. In 1982 petitioner negotiated a lease with the United States Army in which the Army would pay Composite $15,000 per month to least petitioner's Eagle and Composite would then

pay petitioner for the use of the airplane.[6] Petitioner agreed to devote substantially all

In its Confidential Offering Circulars, Composite included expenditures for air show travel expenses when specifying how the proceeds would be disbursed. The Circulars specifically stated that petitioner would make his Eagle available to Composite for demonstration and promotional purposes and would be reimbursed for his expenses in connection therewith. The Confidential Offering Circulars also specified that petitioner had previously advanced funds to

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6 Presumably this is part of the total gross receipts of $189,499.26 reported by Composite on its 1982 corporate tax return and the $110,762.58 deducted for rental expenses that year. It is not clear whether the $110,762.58 was reported as income on petitioner's Schedule C or on the corporate return of either Dietrick Sales and Service or Tailwinds Aviation which had been incorporated in early 1982.of his time to Composite's affairs and work initially without compensation.

cover Composite's expenses and that petitioner would be reimbursed from the proceeds of the offering. The initial circular expressly stated that petitioner could also elect in the future to advance funds on behalf of Composite to cover expenses, and Composite would reimburse petitioner for such advances from the proceeds of the offering available at that time.

In 1980 Composite transferred a total of $91,000 to petitioner. Petitioner executed no notes in favor of the corporation, no interest was specified, and no unconditional promise to repay existed. In addition, in late December of 1980 Composite obtained a loan from a financial institution in the amount of $645,000 that was secured by Treasury bills Composite owned, which were not due until March and June of 1982. Composite then transferred the $65,000 to petitioner. In the 1981 Offering Circular, the above

transfers, plus another bringing the total to $160,800, were characterized as loans from Composite to petitioner. Petitioner was not sure how he would ultimately treat the $65,000 transfer from Composite to himself. If Composite were to be liquidated or sold, petitioner wanted the loan amount taken out of the proceeds and petitioner would then report the loan as income to himself. If Composite proved successful, petitioner wanted to repay the loan to Composite or use it as the basis for the cost of additional shares in Composite. As with the previous transfer of $91,000 from Composite to petitioner, no note existed between Composite and petitioner as to the $65,000, no interest was charged, and no unconditional promise to repay existed. That was the situation as to the entire $160,800 "loan" referred to in the 1981 circular.[7]

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[7] The $160,800 characterized in the January 1981 Offering Circular as a "loan" to petitioner represented the total capital contributions received from the first two stock offerings.

On his 1980 Schedule C, petitioner deducted as part of his cost of goods sold or as expense the $137,638.31 he recorded in Account 22 as expenses he paid for Composite.[8] On March 15, 1984, respondent issued a statutory notice of deficiency to petitioner for the 1980 tax year. Respondent disallowed most of the Account 22 expenditures that petitioner had claimed as deductions on his Schedule C as cost of goods sold and as expenses.[9] Except possibly the wages paid to

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[8] The parties have stipulated that these various Account 22 amounts were as follows:

$ 36,022.20	Wages & withholding taxes for Alther
69,346.91	Travel, Engineering, etc.
5,591.76	Consultants
14,552.64	Life Insurance
8,230.16	Legal Fees
3,894.64	Advertising
TOTAL $137,638.31	

[9] In addition to disallowing certain other advertising and depreciation expenses, the nature of which is not explained by the record, respondent disallowed Account 22 expenditures as follows:

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Alther, discussed above, the disallowed Account 22 expenditures represented corporate expenses of Composite Aircraft Corporation that petitioner had paid. In addition, respondent disallowed a medical deduction of $2,018.77 due to the increase in the amount of petitioner's adjusted gross income because of the disallowed deductions.

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	Account 22 Amount (See n.8, supra)	Amount Disallowed
	$ 36,022.20	$ 36,022.20*
	69,346.91	48,200.00**
	5,591.76	5,591.76
	14,552.64	14,552.64
	8,230.16	4,115.08***
	3,894.64	3,894.64
TOTAL	$137,638.31	$112,376.32

* Respondent actually disallowed $40,000 for labor. The record does not explain this discrepancy of $3,977.80.

** Respondent allowed $18,146.91 for Midland Office expense and $3,000 for supplies, apparently as expenses of the sole proprietorship.

*** Respondent allowed half of this legal expense, apparently as an expense by the sole proprietorship.

On October 31, 1984, respondent issued a statutory notice of deficiency to petitioner for the 1982 tax year. In this notice of deficiency respondent disallowed a net operating loss carryover of $84,392.97 from petitioner's 1981 tax year that petitioner had used on his 1982 individual tax return. This net operating loss carryover was the result of petitioner's claiming deductions in 1981 on his Schedule C as cost of goods sold and as expenses of amounts recorded on Account 22.[10] Except possibly the wages paid to Alther,

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[10] In addition to other adjustments to petitioner's 1981 tax return, respondent disallowed the following Account 22 expenditures:

$20,050.45	Alther's wages
11,915.39	Consultants
2,665.05	Withholding taxes
29,843.45	Midland expenses (including $9,600 rent)
1,717.19	Advertising
1,129.84	Legal and professional
3,638.16	Life Insurance
$70,959.53	

discussed above, these Account 22 expenditures represented corporate expenses of Composite Aircraft Corporation that petitioner had paid. Respondent also disallowed expenditures totaling $4,082.37 for the 1982 year, which were recorded on Account 22 for Composite's expenses for that year, that petitioner claimed as deductions on his Schedule C as part of his cost of goods sold.

OPINION

Section 162(a) allows a taxpayer to deduct all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade of business."[11] Under

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[11] In pertinent part, section 162 provides as follows:

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

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section 162 the payment by one taxpayer of an expense of another taxpayer's trade or business is not deductible. Deputy v. du Pont, 308 U.S. 488, 494 (1940); Welch v. Helvering, 290 U.S. 111, 115 (1983). As a general rule, the trade or business of a corporation is not also a trade or business of its shareholders. Whipple v. Commissioner, 373 U.S. 193, 202 (1963). Shareholders do not engage in a trade or business when they invest in the stock of a corporation. 373 U.S. at 202. Thus, a shareholder is generally not permitted to deduct from his personal income his payment of the corporation's expenses. Deputy v. du Pont, supra; Betson v.

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(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Commissioner, 802 F.2d 365, 368 (9th Cir. 1986), affg. on this issue a Memorandum Opinion of this Court; Rink v. Commissioner, 51 T.C. 746, 751 (19698). The expenditures, if not loans, are considered capital contributions under section 263. Betson v. Commissioner, supra, 802 F.2d at 368. Sums advanced with the intent of yielding income from business operations in future years are generally considered capital contributions. Betson v. Commissioner, supra, 802 F.2d at 371.

An exception to this general rule exists if the taxpayer pays the expenses of another to protect or promote his own trade or business. Gould v. Commissioner, 64 T.C. 132, 134-135 (1975); Lohrke v. Commissioner, 36 T.C. 886, 895 (1961). In that instance the taxpayer may take the deduction, even though the transaction that gives rise to the payments originated with another person and would have been deductible by that other

person if that other person had made the payment. Gould v. Commissioner, supra, 64 T.C. at 134-135; Lohrke v. Commissioner, supra, 48 T.C. at 684-685; Pepper v. Commissioner supra, 36 T.C. at 895; Dinardo v. Commissioner, 22 T.C. 430, 436 91954); L. Heller & Son, Inc. v. Commissioner, 12 T.C. 1109, 1112 (1949).

The first issue for decision is whether petitioner paid his corporation's expenses in order to protect or promote his sole proprietorship and so may deduct his payments of the expenses of another taxpayer, Composite. Respondent argues that petitioner is not entitled to deduct Composite's expenses because petitioner may not deduct the expenses of another taxpayer and does not come within any exception to that general rule. On the other hand, petitioner contends that his payment of Composite's expenses is fully deductible since

petitioner paid these expenses to protect or promote his sole proprietorship.[12]

Under the exception the taxpayer must make the payments to retain or protect the taxpayer's existing, ongoing business rather

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[12] Representing themselves during trial, petitioners essentially disregarded the fact that Mr. Dietrick's corporation, Composite Aircraft, is a legal entity separate and apart from Mr. Dietrick or his sole proprietorship. Mr. Dietrick argued that he should be able to deduct the corporation's expenses because he was working for Composite without compensation and the "only compensation I get from it is through my Schedule C [i.e., offsetting corporate expenses against his income from other sources]. He further argued that the corporate expenses were deductible by him on his personal returns because they somehow represented the expenses of "splitting out" Composite and later two other corporations from his sole proprietorship. As he explained it, "in my mind, my Schedule C was actually giving birth to these three companies." We note, however, the Mr. Dietrick's sole proprietorship [his "Schedule C" as he called it] was not in the trade or business of promoting corporate enterprises. See, for example, Townshend v. United States, 384 F.2d 1008, 1011-1013 (Ct. Cl. 1967). Retained only to brief the case, petitioners' counsel wisely abandoned these untenable arguments and relied upon a plausible legal theory. He presented that theory in well-reasoned, carefully crafted briefs that suffered only from inadequate factual support in the record.

than to acquire, invest in, or establish a new business. Pepper v. Commissioner, supra, 36 T.C. at 895; Snow v. Commissioner, 31 T.C. 585, 591 (1958).[13] In Dodd v. Commissioner, 298 F.2d 570 (4th Cir. 1962), affg. a Memorandum Opinion of this Court, the taxpayer operated his sole proprietorship and a corporation from the same address with the same employees and many of the same customers. Due to the fact that the corporation was undercapitalized, the taxpayer advanced funds to the corporation to meet current operating expenses. The corporation reimbursed the taxpayer for some of the funds the taxpayer advanced for the corporation's benefit. The taxpayer, however, deducted the unreimbursed amounts and stated that the payments were made to protect and preserve the credit and

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[13] See also Modell v. Commissioner, T.C. Memo. 1983-761; Holman v. Commissioner, T.C. Memo. 1973-279; Jones Beach Theatre Corp. v. Commissioner, T.C. Memo. 1966-100.

goodwill of his sole proprietorship. The Fourth Circuit stated that the taxpayer's position reduced itself "to the contention that his own individual business and that of the corporation were so intertwined as to be virtually one, and the expenses of the corporation (to the extent of the advances not repaid) presumably deductible by the corporation itself, were also deductible expenses of the taxpayer's separate business." 298 F.2d at 573. The Fourth Circuit stated that the taxpayer's position reduced itself "to the contention that his own individual business and that of the corporation were so intertwined as to be virtually one, and the taxpayer, however, deducted the unreimbursed amounts and stated that the payments were made to protect and preserve the credit and goodwill of his sole proprietorship. The Fourth Circuit stated that the taxpayer's position reduced itself "to the contention that his own individual business and that of

the corporation were so intertwined as to be virtually one, and the expenses of the corporation (to the extent of the advances not repaid) presumably deductible by the corporation itself, were also deductible expenses of the taxpayer's separate business." 298 F.2d at 573. The Fourth Circuit stated that the taxpayer's position reduced itself "to the contention that his own individual business and that of the corporation were so intertwined as to be virtually one, and the expenses of the corporation (to the extent of the advances not repaid) presumably deductible by the corporation itself, were also deductible expenses of the taxpayer's separate business." 298 F.2d at 573. The Fourth Circuit disagreed. The Fourth Circuit disallowed the deductions, finding that the taxpayer's purpose in making the advances was to establish a new business and pay the current expenses of the corporation in order to keep it in existence. 298 F.2d at 578.

The court found that any benefits to the credit rating or goodwill of the taxpayer's payments of the corporate expenses were just contributions to capital. 298 F.2d at 578.

In addition to the fact that the payment must be made to retain or protect the taxpayer's existing business, the other entity that incurred the expense must previously have provided the taxpayer's trade or business with income or other benefits. In Dinardo v. Commissioner, 22 T.C. 430 91954), we held that the taxpayer's medical partnership could deduct payments it made to cover the operating deficits of a nonprofit corporation that the taxpayer had previously organized to operate a private hospital. The taxpayer had initially organized the hospital to protect and augment the taxpayers's medical practice. The Court found that the taxpayer made the payments in question to keep the hospital in operation so that the taxpayer could continue to earn medical fees from patients who would come or

be sent to the taxpayer because of the taxpayer's access to the hospital. 22 T.C. at 435-436. The Court reasoned that the payments were not capital advances made to finance a new enterprise but payments so the taxpayer could continue to receive the additional medical fees from his medical practice. 22 T.C. at 438.

In Lohrke v. Commissioner, supra, 48 T.C. at 688, the above standards were refined and restated by this Court. The Court specified that two elements must be met before a taxpayer can deduct the ordinary and necessary business expenses of another taxpayer under the protect-or-promote exception. In that case the taxpayer received a substantial amount of royalty income from the licensing of a patent on a process used in the synthetic fiber industry. The taxpayer also had a substantial interest in a corporation that used the patented process in the conversion of synthetic fibers into fabrics. When the

corporation made a shipment of defective fiber to a customer, the taxpayer agreed to be held personally liable. The taxpayer agreed to this because the corporation could not afford to lose the sale of the fiber and the taxpayer did not want to lose the benefits that he, as a licensor and inventor of the patented process, derived from having access to the manufacturing facilities of the corporation. The taxpayer tried to deduct the payments he made for the resulting losses.

This Court in Lohrke v. Commissioner, supra, 48 T.C. at 688, established two elements or a two-prong test to determine whether a taxpayer could deduct the expenses of another person. The first element is whether the taxpayer's purpose or motive for paying the obligation of the other entity is to protect or promote the taxpayer's own trade or business. 48 T.C. at 688. The second element is whether the expenditure is an

ordinary and necessary expense of the taxpayer's own trade or business. 48 T.C. at 688.

In Lohrke v. Commissioner we found that the taxpayer's primary motive for paying the obligation of the corporation was to protect his individual licensing business, which was receiving several benefits from the continued existence of the corporation. 48 T.C. at 689. These benefits included using the corporation as a pilot plant so prospective licensees could sample the fiber processed by the patented process and using the corporation to gain a sufficiently intimate knowledge of trade activities so the taxpayer would know whether companies were using the patented process without a license or paying inadequate royalties.

As to the second element or prong of the test, in determining what is an ordinary and necessary business expense, necessary means appropriate and helpful. Welch v. Helvering,

290 U.S. 111, 113 (1933). Ordinary does not mean that the payments must be habitual or normal to the taxpayer but, instead, denotes payments that are a common and accepted means of protecting or promoting the taxpayer's own trade or business. Welch v. Helvering, supra, 290 U.S. at 114. In Lohrke v. Commissioner, supra, 48 T.C. at 689, we found that the taxpayer's payment was proximately related to his individual licensing business and so was ordinary and necessary. 48 T.C. at 689. Thus, the taxpayer was entitled to deduct the payment as an ordinary and necessary business expense of carrying on his licensing business.

In this case petitioner attempts to defend his deductions for payments he made for Composite by claiming that he comes within the protect-or-promote exception to section 162. Petitioner claims that he was trying to protect or promote his sole proprietorship,

Dietrick Sales and Service, when he paid the expenses of Composite. Under the general rule of section 162, once petitioner incorporated Composite he was no longer entitled to deduct the payment of Composite's expenses on his individual income tax return. To determine whether the exception applies we will apply the two-prong test of Lohrke v. Commissioner, supra. Petitioner bears the burden of demonstrating that he satisfies each prong of the test. Rule 142(a).

Under the first element of the two-prong test in Lohrke v. Commissioner, supra, 48 T.C. at 688, petitioner must demonstrate that his purpose or motive for making the payment was to protect or promote petitioner's sole proprietorship. Petitioner argues that he paid Composite's expenses to both financially benefit his sole proprietorship and protect the goodwill or reputation of his own business. Petitioner first argues that the

expenses he paid were incurred to organize and obtain financing for Composite so that his sole proprietorship could later derive income by selling NUF to Composite to make the Eagle airplanes. Since petitioner owned the machine that produced the NUF material, petitioner contends that it was critical for him to ensure Composite's success so he could earn money on his investment in the machine.

We find that petitioner's primary motive for paying Composite's exenses was to establish a new business rather than protect or promote his sole proprietorship. Petitioner wants the best of both worlds in which he can take advantage of the benefits of incorporation while personally deducting the expenses of the corporation. Under the protect-or-promote exception to section 162, petitioner's payments are not deductible since the payments were made so petitioner could establish a new business rather than protect

or promote his sole proprietorship. The protect-or-promote exception only applies if the payments are made to retain or protect an existing business rather than establish a new business. Dodd v. Commissioner, supra, 298 F.2d at 573.

Petitioner initially attempted to market the Eagle on his own through his sole proprietorship. However, petitioner decided to set up a corporation for production of the Eagle for a number of good business reasons: his belief that the best way to finance production of the Eagle was through contributing shareholders; his wish to separate the Eagle aircraft project from his sole proprietorship, which dealt primarily with oil filtration; and his desire for continuity of the Eagle aircraft business in case anything happened to him. The expenses of Composite that petitioner paid included expenses incurred in organizing the new

corporation and trying to obtain adequate financing so Composite could commence production of the Eagle. In addition, petitioner, as the president, director, and principal shareholder, agreed to advance funds to Composite until such time as Composite could reimburse him from the proceeds of the private offerings or otherwise. The fact that petitioner (either through his sole proprietorship or perhaps through his other corporations -- Dietrick Sales and Service or Tailwinds Aviation) might benefit from Composite's possible future success is not sufficient to bring this case within the protect-or-promote exception.

In addition, in Lohrke v. Commissioner, supra, and Dinardo v. Commissioner, supra, we held that the taxpayers could deduct the expenses of another legal entity because the taxpayer's own trade or business had previously received benefits from the

corporations whose expenses they paid. The taxpayers in those cases paid the corporations' expenses only when the taxpayers thought that their own trade or businesses might lose those benefits. In this case neither petitioner's sole proprietorship nor his other two corporations had ever received any benefits from Composite and had he done so, it would have been furnished "at his cost" (see n.3, supra); petitioner never received any compensation for consulting services rendered to Composite. Hence, petitioner's argument that payment of Composite's expenses was to protect or promote "his business of supplying N.U.F. and consulting services to Composite" is mere theory without a factual basis.

Petitioner also speculates that Dietrick Sales and Service (sole proprietorship or closely held corporation) runs the risk of being placed in "severe financial straits"

unless Composite proves successful. Petitioner has offered no proof that Dietrick Sales and Service would be placed in any financial danger if petitioner had not paid Composite's expenses. In fact, Dietrick Sales and Service has been in business since 1959 and its principal business was the filtration operations, not the fledgling aircraft business Mr. Dietrick was trying to launch. Without any sale of NUF to Composite, Dietrick Sales and Service continued its profitable filtration business and was incorporated in 1982. In fact the record does not establish whether the NUF machine was transferred to the new Dietrick Sales and Service Corporation in 1982, was transferred to Tailwinds Aviation, or remained as one of Mr. Dietrick's personal assets.

Petitioner contends that by specifying both "protect" and "promote" in the exception to section 162 in Lohrke v. Commissioner,

supra, this Court intended to include both the protection of prior benefits or income and the promotion of possible future income or benefits. Petitioner argues that his payment of Composite's expenses falls within the exception since he intended to promote his sole proprietorship through Composite's use of NUF material in the future. We disagree with this analysis factually for the reasons stated above and also legally. This court did not intend to include benefits that had never materialized prior to the taxpayer's payment of expenses under the protect-or-promote exception. It is too speculative to guess whether benefits that have not materialized by the time the taxpayer pays his corporation's expenses might have benefited the taxpayer's own separate trade or business. Thus, we find that petitioner's primary motive for paying Composite's expenses was not to financially

benefit his sole proprietorship or his other corporations since they had never received any financial benefits from Composite, either prior to the payment of these expenses or up to the time of trial.

Petitioner also argues that his motive for paying Composite's expenses was to protect or promote his trade or business through the protection of his own business' goodwill or reputation, relying on Jenkins v. Commissioner, T.C. Memo. 1983-667. In that case this Court held that one means of protecting a taxpayer's trade or business was to protect that trade or business' reputation.[14] In Jenkins v. Commissioner the taxpayer, country music entertainer Conway Twitty, repaid the investors, who included the taxpayer's friends and business associates,

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[14] See also H. Kalicak Construction Co. v. Commissioner, T.C. Memo. 1984-552; Modell v. Commissioner, T.C. Memo 1983-761.

the amounts they invested in Twitty Burger corporation. We found that the taxpayer made those payments with the primary motive of protecting his personal business reputation in his ongoing business of being a country music entertainer. The Court found that the possibility of extensive adverse publicity concerning the taxpayer's involvement in the defunct corporation, which would reflect on the taxpayer's reputation for integrity, was a very likely possibility. The Court based this determination on both the taxpayer's testimony that allegations of fraud against him, with several investors threatening to sue him, could ruin the positive image that he had carefully built over the years, and the expert testimony of the Director of County Music Foundation who testified that a country music entertainer's character, personality, and credit reputation are part of his role as a country singer and have an effect on the popularity of that singer.

Petitioner bears the burden of proving that the nonpayment of Composite's expenses would have adversely affected petitioner's business reputation. Rule 142(a). Petitioner has not established that he paid Composite's expenses to maintain his own or his other corporation's reputation or goodwill. Petitioner claims that he was an entrepreneur who relied on his reputation for good business acumen to attract investors to his business enterprises. Unlike the taxpayer in Jenkins v. Commissioner, supra, petitioner offered no evidence to demonstrate that the failure of Composite to pay its expenses would reflect unfavorably on either the reputation of Dietrick Sales and Service or the reputation of petitioner himself as a businessman. Without such evidence petitioner has failed to meet his burden of proof.

Moreover, we note that each of the private Offering Circulars expressly warned

potential investors that Mr. Dietrick had no experience in the aircraft industry other than as a private pilot. Those circulars also warned potential investors that if Windecker Industries:

> which was larger and better capitalized than [Composite] was unable to manufacture and market the Eagle on a commercially successful basis, there can be no assurance that [Composite] will be able to manufacture and market the Eagle successfully.

In other words, there is no evidence that anyone was relying upon the business reputation of Mr. Dietrick or of his sole proprietorship/corporation, Dietrick Sales and Service. Likewise, there is no evidence that the success or failure of Composite's Eagle aircraft business would have any impact on petitioner or his other business activities. Thus, petitioner has failed to prove that his primary motive for paying Composite's expenses was to protect or promote petitioner, his sole proprietorship, or his other corporations,

either financially or through their reputation.

The second element of the two-prong test in Lohrke v. Commissioner, supra, 48 T.C. at 688 is whether the payment was an ordinary and necessary expense of the taxpayer's own trade or business. Since both prongs of the test must be met and we have determined that petitioner has not met the first prong, we need not determine whether this second element has been met. However, the same facts discussed at length above establish that petitioner also could not met this test. Petitioner's payment of Composite's expenses was not proximately related to his own separate trade or business.

Even if the protect-or-promote exception were applicable to petitioner, and we have concluded it was not, petitioner still could not deduct the payment of expenses for which he was reimbursed by Composite. A taxpayer cannot deduct payments for expenses for which

he has been reimbursed by the corporation. In Composite's Confidential Offering Circulars, Composite included air show travel expenses as one of the purposes for which the proceeds would be disbursed. The circulars specifically stated that Mr. Dietrick, would use his own Eagle airplane "for demonstration and promotional purposes and will be reimbursed for his expenses in connection therewith." In addition, Composite specified in its Confidential Offering Circulars that petitioner would be reimbursed for payments he made on behalf of Composite. Petitioner attempted to deduct on his own Schedule C payments of $137,638.31 for 1980, $87,959.27 for 1981, and $4,082.37 for 1982. However, Composite transferred a total of $156,000 to petitioner in 1980, and an additional amount in 1981 to bring the total up to $160,800, the total capital contributions received in the firt two offerings. The parties in this case disagree as to the proper characterization of

these transfers of funds. Petitioner says these transfers of funds were loans to him from Composite. Respondent says these transfers of funds were reimbursements to petitioner for the corporate expenses he had paid.

The third Offering Circular in early 1981 characterized the $160,800 transfers as "loans" from Composite to petitioner. Thus, petitioner argues the funds were not reimbursements of expenses he had paid. The primary test used to determine whether a distribution from a corporation is a dividend or a loan is the intent to repay or retain the amounts. Estate of Chism v. Commissioner, 322 F.2d 956, 960 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; Pierce v. Commissioner, 61 T.C. 424, 430 (1974); Nasser v. United States, 257, F.Supp. 433, 447 (N.D. Cal. 1966). This determination is a question of fact to be determined from all of the circumstances. Estate of Chism v. Commissioner, supra, 322 F.2d at 960. The

taxpayer bears the burden of proof. Welch v. Helvering, 290 U.S. 111,115 (1933). Although this case does not deal with the dividend versus loan issue, the same intent test applies to determine whether a transfer is a loan or a reimbursement for the shareholder's payment of the corporation's expenses. Frequently, the inquiry is whether an amount paid to a corporation by a shareholder is a loan or a contribution to capital. Here, with a corporation that is vastly undercapitalized for its business of developing, manufacturing, and selling a new type of airplane, we have the anomalous situtation of the corporation making a distribution of its limited funds to the prinipal shareholder, purportedly as "loans."

An inquiry into the subjective intent of petitioner requires an examination of both his testimony and the objective evidence of intent. This objective evidence includes: (1) whether the transferor corporation was closely

held, (2) whether notes were executed, (3) whether the purported obligation was secured by collateral, (4) whether there were fixed dates or a schedule for payment, (5) whether interest was paid or accrued, (6) whether there was a limit to the amount that could be advanced to a shareholder, (7) whether the corporation took steps to collect on overdue "loans," (8) whether any part of the advances were repaid, (9) how the transfers were treated on the books and records, the tax returns and financial statement of the corporation and shareholder, and (10) whether there was a specific business purpose for making the advances. Alterman Foods, Inc. v. United States, 505 F.2d 873, 878-879 (5th cir. 1974); Berthold v. Commissioner, 404 F.2d 119, 121-122 (6th Cir. 1968), affg. a Memorandum Opinion of this Court; Pierce v. Commissioner, 61 T.C. 424, 430-431 (1974).

In this case, although the transfers were labeled as "loans" in the third Offering

Circular and although petitioner testified to that effect, we conclude on the basis of the record as a whole that petitioner has failed to establish that he had any obligation to repay, or intent to repay, these funds to Composite. Petitioner claims that the transfers were loans, pointing out that he repaid $25,000 of the $65,000 loan Composite had borrowed from a bank when Composite's note to the bank came due. Petitioner offered no objective evidence to prove that the transfers to him were loans. No note was ever executed by petitioner, no agreement existed between Composite and petitioner stating that the transfers were loans, no mention of collateral was made, no schedule existed for repayment, no interest was specified, and the loans transaction was not recorded as such on the corporate books or records. In fact, petitioner testified that he was uncertain as to how he would ultimately characterize the $65,000 transfer. In light of this,

petitioner's testimony that the transfers were loans and the characterization of the transfers as a loan in Composite's third Offering Circular to not satisfy petitioner's burden of proof. We hold that even if the protect-or-promote exception applied to petitioner, he still could not deduct those expenses for which he received reimbursement from Composite.

Lastly, petitioner claims that even if he cannot deduct the payments under the protect-or-promote exception, he properly deducted Alther's salary on Schedule C of his individual income tax return. Petitioner contends that he should be allowed to deduct 90 percent of Alther's salary since Alther spent at least 90 percent of his time working for the sole proprietorship, the filtration operations, in 1980 and 1981. Respondent argues that salaries of employees who are in the employ of a separate and distinct corporate entity are only deductible by that

entity, citing Columbian Rope Co. v. Commissioner, 42 T.C. 800, 815 (1964); and Young & Rubican, Inc. v. United States, 410 F.2d 1233, 1237 (Cl. Ct. 1969). Respondent says the taxpayer has the burden of proving that a particular individual was involved in a specific activity clearly for the proximate and direct benefit of the taxpayer rather than of that other entity. Young & Rubican, Inc. v. United States, supra, 410 F.2d at 1239.

In this case, at the time Composite hired Alther as an aeronautical engineer, petitioner and Alther agreed to a contingency plan under which Alther would work for the filtration operation if Composite could not attract sufficient financing to commence production of the Eagle. Composite never received the amount of capital contributions that were necessary to begin production of the Eagle. Although Alther remained an employee of Composite throughout the years in issue and received his W-2's from that corporation, he

spent most of his time working for the filtration businsss and his wages were actually paid by Mr. Dietrick in 1980 and 1981.[15]

Petitioner argues that when Composite could not obtain adequate financing to begin production of the Eagle, Alther was reassigned, according to his agreement with petitioner, to do consulting work for Dietrick Sales and Service. Although Alther used the name "Alther Engineering," we find that he only did so because his name was better known than Composite's and not because he was no longer working for Composite.

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[15] To a minor extent in 1981 and in 1982 and subsequent years, Alther's engineering services rendered under the name of "Alther Engineering" apparently produced income that was deposited into Composite's corporate account, and used to pay at least part of Alther's salary and expenses. However, the only Alther wages in dispute in this case are those amounts paid by Mr. Dietrick in 1980 and 1981. See nn. 4,5,8,9,10, supra.

However, assuming Alther was Composite's employee and worked in the filtration business as an agent of Composite, that does not mean petitioner would not be entitled to deduct any amounts he actually paid for services actually rendered to his sole proprietorship. The parties seemed to argue this issue as if only Composite or only petitioner could deduct Alther's wage expense. This case is factually distinguishable from Columbian Rope Co. v. Commissioner, supra. This case does not involve a section 482 reallocation of expenses as in Young & Rubican, Inc. v. United States, supra. However, even under that case, a taxpayer who can show that the employee worked part of the time for the proximate and direct benefit of the taxpayer may deduct a percentage of the earnings for the time the employee devoted solely to the taxpayer. Young & Rubicam, Inc. v. United States, supra, 410 F.2d at 1240-1241. The fact situtation in

the instant case is more like the "Kelly Girl" or leased employee case. Petitioner can deduct on his Schedule C any reasonable amounts he paid Composite for services actually rendered by Alther to the filtration operation; Composite should then report that income on its tax return and in turn deduct the amount it actually paid Alther as its corporate employee. That is not exactly what happened, but in essence that is the substance of the transaction. See nn.4,5,15 supra.

Accordingly, we hold that petitioner is entitled to deduct on his Schedule C 90 percent of the $36,022.20 he paid for Alther's wages and withholding tax in 1980, and 90 percent of the $20,050.45 that he paid for Alther's wages in 1981. However, those amounts must be reduced to the extent that petitioner was reimbursed for such expenditures by Composite.[16]

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[16] For 1980, respondent disallowed $112,376.32 of the Account 22 expenses that petitioner

-Continued-

Except for some portion of Alther's wages, petitioner cannot deduct any payment he made on behalf of Composite on his Schedule C

-Continued-

deducted on his Schedule C for that year, including the $36,022.20 for Alther's wages and withholding taxes. See n.9, supra. For 1981, respondent disallowed $70,959.53 of the Account 22 expenses that petitioner deducted on his Schedule C for that year, including the $20,050.45 for Alther's wages for that year. Thus, respondent disallowed total Account 22 expenses of $183,335.85 ($112,376.32 + $70,959.53), but at most petitioner received net reimbursements of only $135,800 (the total so-called "loans" of $160,800 less the $25,000 portion he repaid of the $65,000 transfer). Accordingly, there were disallowed Account 22 expenditures of at least $47,535.85 ($183,335.85 - $135,800) for which petitioner received no reimbursement from Composite. Thus, 90 percent of the wages and any withholding taxes petitioner paid for Alther's services, up to a maximum of $47,535.85, would be a deductible expense on petitioner's Schedule C. However, it appears that the total fund transfers in 1980 exceeded the disallowed Account 22 expenses that year, so a deduction would be allowable only for 90 percent of the $20,050.45 wage payment in 1981. The parties' Rule 155 computations will determine whether or not that results in a change in the tax liability for 1982, the years before the Court.

since those expenses were those of another taxable entity and petitioner was not protecting or promoting his own trade or business in making the payments.

To reflect the concession and the foregoing holdings,

Decisions will be entered under Rule 155.

APPENDIX D

UNITED STATES TAX COURT

GERALD PATRICK DIETRICK and ANITA LEA DIETRICK,	)	
Petitioners,	)	
V.	)	Docket No. 13616-84
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed April 28, 1988, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1980 in the amount of $70,864.45.

Edna G. Parker
Judge

Entered: June 30, 1988.

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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June 23, 1988.

APPENDIX E

UNITED STATES TAX COURT

GERALD PATRICK DIETRICK and ANITA LEA DIETRICK, Petitioners,	)	
v.	)	Docket No. 42129-84
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed April 28, 1988, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1982 in the amount of $38,421.03.

Edna G. Parker
Judge.

Entered: June 30, 1988.

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

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APPENDIX F

STATUTE INVOLVED

The statute which this case involves is as follows:

(a) IN GENERAL.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for

purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. 26 U.S.C. Sec. 162(a).